MINUTES

OF THE MONETARY COUNCIL MEETING

26 NOVEMBER 2013

Article 3 (1) of the MNB Act (Act CXXXIX of 2013 on the Magyar Nemzeti Bank) defines achieving and maintaining price stability as the primary objective of the Magyar Nemzeti Bank. The MNB's supreme decision-making body is the Monetary Council. The Council convenes as required by circumstances, but at least twice a month, according to a pre-announced schedule. At the second scheduled meeting each month, members consider issues relevant to immediate policy decisions. Abridged minutes of the Council's rate-setting meetings are released regularly, before the next policy meeting takes place. The minutes are divided into two main parts. The first part contains a discussion of economic and financial developments, derived from analyses presented by the Bank staff to the Council, as well as information which has become available since the previous meeting. Taking into account the findings of the first part, the second part goes on to present the decision-makers' assessment of current economic conditions and the factors they consider when deciding on the base rate.

The minutes are available on the MNB's website at:
http://english.mnb.hu/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

1 Macroeconomic and financial market developments

Macroeconomic developments

In October, the annual rate of inflation fell by 0.5 percentage points to 0.9% relative to the previous month. Falling fuel prices and lower food prices accounted for most of the decline in inflation. Core inflation excluding indirect taxes was 1.5%. Measures capturing the medium-term outlook for inflation essentially remained unchanged relative to September and have been at low levels since the beginning of the year. Incoming data suggest that depressed demand is still holding back firms from passing on corporate costs to consumer prices.

According to the preliminary data released by the CSO, in the third quarter of 2013 Hungary's gross domestic product grew by 1.7% year-on-year and by 0.8% compared to the previous quarter, adjusted for seasonal effects. Based on the available monthly indicators, industry, construction and agriculture may have driven third quarter growth on the output side. On the expenditure side, net exports and government sector investment grew markedly, while household and private sector investment growth may have been subdued.

Based on the monthly output data, September saw an increase in the performance of major sectors, and forward-looking indicators point to a continuation of this trend. Industrial production grew by 5.5% year-on-year and by 1.9% relative to the previous month. The auto industry was the main driver of growth. There was a significant, 31% year-on-year rise in new orders. Within this, new export orders grew by 30.6% and new domestic orders rose by 34.3%. Construction industry output grew by 9.3% year-on-year and by 0.9% relative to August. The increase resulted mainly from other contracts for the construction of other structures, but the volume of private building construction also grew. The volume of new contracts stood 49.2% higher year-on-year, which points to a continued increase in output.

The 0.3% year-on-year rise in retail sales suggests continued growth in household consumption on the expenditure side of GDP. The increase was mainly driven by stronger retail fuel sales. Net exports also increased alongside trade in goods in September. The growth rates of both exports and imports rose sharply year on year. The month-on-month expansion in the volume of exports is likely to have been driven by higher export sales. Higher net export volume and the improvement in the terms of trade also contributed to a higher trade surplus.

In September, gross average private sector earnings rose by 3.8% year-on-year as the subdued wage dynamics prevailing since the beginning of the year continued. Employment increased in the third quarter, which may be partly attributed to rising employment in the private sector. The unemployment rate dropped to 9.8% in the third quarter.

Financial market developments

In the period following October's interest rate decision, money and capital markets were shaped by developments related to the monetary policies of leading central banks and by macroeconomic data which diverged significantly across different regions. The possible reduction in the Federal Reserve's asset purchase programme and the senate confirmation hearing of future Chair Janet Yellen were in the focus of investors' attention. The Fed's announcement following its October interest rate decision suggested somewhat tighter monetary policy conditions than expected, which made an impact on markets. In addition, the minutes published at the end of the month dampened sentiment slightly. Following its interest rate cut last month, the European Central Bank (ECB) maintained its forward guidance on holding interest rates low for a protracted period.

Several emerging economy central banks raised interest rates, while Central Europe saw a foreign exchange market intervention by the Czech central bank. Public attention also turned to news about the Chinese government's efforts to change the economic policy framework.

In terms of risk indicators, the VIX index continued its downward path based on positive US macroeconomic data and corporate reports, reaching a nearly two-month low, while the EMBI Global index, a better indicator of emerging regional trends, rose sharply from the end of October. A similar picture emerges for other indicators as well: the US dollar appreciated against emerging country currencies, and while the indices of developed economies reached new highs, emerging economy indicators tended to decrease over the past month. Long-term yields also varied: European long-term yields did not follow in the rise in US government bond yields in November, while bond yields in the CEE region rose far faster than US yields.

In the period following the October interest rate decision, there were few events in Hungary that had an impact on the market, which was thus shaped mainly by international trends. As regards news related to Hungary, the third-quarter GDP figure drew substantial attention and came as a positive surprise to markets, raising expectations. In addition, the far lower-than-expected inflation figure pushed consumer price index estimates downward. Parliament passed a decision to extend the current exchange rate cap for foreign currency borrowers and to ease the programme’s conditions. The issuance of foreign currency bonds by the Government Debt Management Agency on 18 November did not come as a surprise. The packet of ten-year securities worth USD 2 billion was sold at a 325 basis point premium compared to the US benchmark.

The country-specific appreciation of the forint exchange rate seen in earlier weeks faltered. The EUR/HUF exchange rate depreciated by 1.8% to 298 from its previous level of 293, underperforming the Romania leu and Polish zloty exchange rates, which were unchanged. Within the region, the announcement of the intervention weakened the Czech koruna’s exchange rate by a staggering 6%. The Hungarian five-year CDS spread rose by 16 basis points to 278 basis points. Hungarian foreign exchange bond spreads essentially remained the same. Developments in Hungary are in line with those of regional CDS spreads and foreign exchange bond spreads.

The government securities market yield curve steepened markedly in the course of the month. Yields fell tangibly at the short end, while yields at longer maturities rose. The government security auctions held in the past month had mixed results; the announced quantity was reduced due to weak demand during the first part of the month, while stronger demand during the second half led to the issuance of a larger quantity than announced.

Position of the banking sector

The level of the MNB’s Financial Conditions Index (FCI) in the third quarter of 2013 indicates that financial conditions impaired economic growth to a lesser extent. Following an improvement in the second quarter, the index continued to approach zero in the third quarter as well.

There was a HUF 18 billion increase in the banking system’s corporate loan portfolio. This slight increase resulted from a HUF 48 billion decline in foreign currency loans and a HUF 66 billion increase in forint-denominated loans. In the household segment, loans outstanding continued to decline in October. The decline amounted to HUF 34 billion and only affected the foreign currency loan portfolio. The average interest rate on newly disbursed household housing loans fell further in September and essentially remained the same in the case of home equity loans.

The System-Wide Financial Stress Index, a measure of the level of stress from the sub-markets of key importance for financial stability, remained at a low level in the past month and at a distance from the danger zone.

The Liquidity Stress Index remained essentially unchanged at 7.9%, while the positive liquidity buffer increased. At the level of individual banks, none would be left insolvent in the wake of a shock. Overall, the liquidity position can thus be regarded as adequate. The ratio of non-performing household loans rose to 18.3% in the third quarter. The profit-reducing impact of provisioning rose by less than 0.1% to 2.8%. A slight increase in the number of defaults coupled with rising impairment maintained loan loss coverage at over 50%. The ratio of borrowers with loans overdue for more than 90 days fell to 19.5% within the corporate portfolio. This also resulted from an increase in the corporate loan portfolio for the first time since the onset of the crisis, along with the relatively low portfolio deterioration. The profit-reducing impact of provisioning fell slightly to 3.2%. This was sufficient to maintain coverage of over 55%.

At the end of October, the sector’s cumulated pre-tax profits amounted to HUF 86 billion, substantially higher than last year’s HUF 21 billion, but still low by historical standards. One single bank accounted for the bulk of this figure, recording pre-tax profits of HUF 139 billion. Four of the large banks posted losses.

The average capital adequacy ratio decreased somewhat, standing at 16.45% in late September 2013, while the distribution of capital adequacy remains asymmetrical. The results of the Solvency Stress Index launched in Q2 2013 and applying to a two-year horizon indicate a lower stress level compared to the previous period.

2 The Council’s assessment of current economic conditions and the interest rate decision

In the Council’s judgement, the expansion of the Hungarian economy was likely to continue this year, followed by a further pick-up in growth next year. While the pace of activity was strengthening, the level of output remained below its potential, and high, but falling unemployment exceeded its long-term level determined by structural factors. The Council expected external economic activity to strengthen gradually and weak domestic demand conditions to persist. As a result, inflationary pressures in the economy were likely to remain subdued in the medium term.

Inflation had continued to fall in October, mainly reflecting developments in food and administered prices, in addition to the decline in fuel prices. The Bank’s measures of underlying inflation capturing medium-term developments in inflation had remained broadly unchanged relative to previous months. The low rate of underlying inflation since the beginning of the year reflected the disinflationary impact of weak domestic demand and the external environment. Subdued wage dynamics suggested that companies were adjusting to higher production costs mainly through the labour market, and therefore the pass-through into consumer prices was likely to be limited and gradual. The low inflation environment might help anchor inflation expectations. In the Council’s judgement, therefore, inflationary pressures were likely to remain moderate over the medium term as well. In the current environment, monetary policy could contribute to meeting the inflation target over the medium term by maintaining accommodative monetary conditions.

The preliminary estimate of GDP growth for the third quarter suggested a gradual improvement in the outlook for economic growth. Growth was expected to accelerate further in the coming quarters, driven by both exports and domestic demand components. The improvement in domestic demand was likely to be gradual, reflecting ongoing deleveraging and the cautious behaviour of households. Export growth was likely to continue in line with the expansion in external demand, which was expected to strengthen markedly starting from the end of this year.

Overall, the global financial environment had been volatile recently, due to uncertainty about the future of unconventional measures used by global central banks. There had been a slight deterioration in perceptions of the risks associated with the Hungarian economy, simultaneously with a new wave of capital outflows from emerging markets. In the Council's judgement, the global financial environment remained supportive on the whole, but volatile sentiment in global financial markets continued to pose a risk, which in turn called for maintaining a cautious approach to policy. Several members of the Council noted that the ECB's latest interest rate cut and possible future liquidity-boosting measures pointed to the persistence of this supportive financial environment.

In the Council's judgement, there remained a significant degree of unused capacity in the economy and inflationary pressures were likely to remain moderate over a sustained period. A further reduction in interest rates was consistent with meeting the 3% inflation target in the medium term. Global financial markets continued to be volatile. A sustained and marked shift in perceptions of the risks associated with the Hungarian economy might influence the room for manoeuvre in monetary policy.

In view of the above, Council members agreed that developments in inflation and the real economy were consistent with a further easing in monetary conditions. However, decision-makers disagreed on the magnitude of the interest rate cut. One member noted that perceptions of the risks associated with the Hungarian economy were shaped mainly by external events that appeared highly fragile; therefore, the slope of the yield curve should be monitored closely along with changes in non-resident holdings of forint-denominated bonds, which could warrant an even more cautious interest rate cut than earlier. The other members of the Council, however, did not see the need to slow further the pace of already cautious monetary easing, in view of developments in inflation and the real economy and the supportive international environment. Members of the Council in favour of a 20 basis point cut agreed that global financial market prospects could not be predicted with great certainty, but preventive measures were not warranted in the absence of any clear signs of such risks, especially at a time when conditions in the real economy and the outlook for inflation called for further easing.

After the discussion, the Chairman invited members to vote on the propositions. Seven members voted in favour of a 20 basis point reduction in the base rate and one member voted for a 10 basis point cut.

In the Council's view, considering the outlook for inflation and the real economy and taking into account perceptions of the risks associated with the economy, further cautious easing of policy might follow.

Votes cast by individual members of the Council

In favour of reducing the base rate to 3.20%	**7**	Ádám Balog, Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Csaba Kandrács, György Kocziszky, László Windisch
In favour of reducing the base rate to 3.30%	**1**	Gyula Pleschinger

The following members of the Council were present at the meeting:

Ádám Balog
Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
Csaba Kandrács
György Kocziszky
Gyula Pleschinger
László Windisch

The Council will hold its next policy meeting on 17 December 2013. The minutes of that meeting will be published at 2 p.m. on 8 January 2014.